ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Arambula	Analyst:	Darrine Distefano	Bill Number:	AB 2567
Related Bills:	See Legislative History	Telephone:	845-4142	Introduced Date:	February 23, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Renewable Technologies Research Expense Credit

SUMMARY

This bill would allow a 20% research expense credit for specified research activities within the state.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to provide a new source of research funding for Cleantech, an emerging industry, in California. Cleantech is a new industry that encompasses a broad range of products and services for alternative energy generation, wastewater treatment, and environmentally friendly consumer products.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2007.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business, including research and experimental expenditures.

Existing federal law allows taxpayers a research credit that is combined with several other credits to form the general business credit. The research credit is designed to encourage companies to increase their research and development activities.

Board Position:			Department Director	Date
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To qualify for the credit, research expenses must qualify as an expense or be subject to amortization, be conducted in the U.S., and be paid by the taxpayer. The research must be experimental or laboratory research and pass a three-part test as follows:

1. Research must be undertaken to discover information that is technological in nature. The research must rely on the principles of physical, biological, engineering, or computer sciences.
2. Substantially all of the research activities must involve experimentation relating to quality or to a new or improved function or performance.
3. The application of the research must be intended for developing a new business component. This is a product, process, technique, formula, or invention to be sold, leased, or licensed, or used by the taxpayer in a trade or business.

Ineligible expenses include seasonal design factors; efficiency surveys; management studies; market research; routine data control; routine quality control testing or inspection; expenses incurred after production; or development of any plant, process, machinery, or technique for the commercial production of a business component unless the process is technologically new or improved.

The federal credit does not apply to any expenses incurred after December 31, 2005. There is pending federal legislation, S 2020, which would extend the credit to apply to expenses incurred during 2006.

California conforms to the federal credit with the following modifications:

- The state credit is not combined with other business credits.
- Research must be conducted in California.
- The credit percentage for qualified research in California is 15% versus the 20% federal credit.
- The credit percentage for basic research in California, available only to corporations, is 24% versus the 20% federal credit.
- The percentages for the alternative incremental research portion of the credit vary from the federal credit.

The California research credit is allowed for taxable years beginning on or after January 1, 1987, and is permanent.

<u>THIS BILL</u>

Under the Personal Tax Law (PITL) and the Corporation Tax Law (CTL), this bill would add a research credit of 20% for qualified research conducted within California by a qualified taxpayer.

This bill defines “qualified research” as the development of renewable technologies, including cleaner air and water, the reuse of materials, and disturbances in greenhouse gas emissions related to biomass, solar, wind, and hydrogen.

This bill defines "qualified taxpayer" as a taxpayer whose total California business activities income does not exceed one million dollars ($1,000,000) per year.

IMPLEMENTATION CONSIDERATIONS

Under the CTL, the research credit allows a 24% credit for basic research conducted in the state. The author may wish to add language to allow a taxpayer that is conducting basic research for renewable technologies to utilize the credit offered under this bill.

This credit would require the addition of a worksheet to the tax forms booklets that can be implemented during the department's annual update; however, by adding a separate research credit, this may cause confusion for taxpayers as to which credit to claim.

The term "business activities" under the definition of qualified taxpayer needs to be clarified. It is unclear if activities apply to all of the taxpayer's business activities or each line of the business if the taxpayer's business is diversified.

LEGISLATIVE HISTORY

AB 2032 (Lieu, 2005/2006) would increase the amount of the qualified research expense credit from 15% to 18% for taxable years beginning on or after January 1, 2007. This bill is currently referred to the Assembly Revenue & Taxation Committee.

AB 483 (Harman, 2001/2002) and SB 1165 (Brulte, 2001/2002) both would have increased the credit for qualified research expenses from 15% to 20%. AB 483 was held in the Senate Revenue and Taxation Committee. SB 1165 failed to pass out of the house of origin by the constitutional deadline.

AB 511 (Stats. 2000, Ch. 107) increased the state credit for qualified research expense from 12% to 15%.

SB 705 (Stats. 1999, Ch. 77) increased the state credit for qualified research expense from 11% to 12%.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida excludes from the payroll factor for apportionment purposes compensation attributable to *Florida* that is dedicated exclusively to research and development activities performed pursuant to sponsored research contracts with a state university or certain nonpublic universities. This exclusion is for corporate income tax purposes only as *Florida* does not have a personal income tax.

Illinois corporate and individual taxpayers may claim an income tax credit for qualified expenditures that are used for increasing research activities in *Illinois*. The credit equals 6 1/2% of the qualifying expenditures.

Massachusetts allows corporate taxpayers to claim an income tax credit for qualified expenditures that are used for increasing research activities in *Massachusetts*. The credit is 15% of the basic research expenses and 10% of qualified research expenses conducted in *Massachusetts*.

Michigan corporate taxpayers may claim an income tax credit equal to 6 1/2% of qualified research expenses that relate to their pharmaceutical research and development.

Minnesota allows corporate taxpayers a credit equal to 5% for qualified research expenses up to $2 million. The amount of the credit is reduced to 2.5% for expenses exceeding the first $2 million.

Beginning in 2005, *New York* allows a credit for qualified emerging technology companies. The credit is equal to 18% of the cost of research and development property, 9% of the qualified research expenses, or the costs of high-technology training expenditures paid by the taxpayer. The credit is limited to $250,000 per taxable year.

None of these states provide an income tax credit specifically for renewable technologies research and development costs. Most of these states use the federal definition for research expenses.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

The revenue impact of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of AB 2567 As introduced February 23, 2006 Effective for tax years beginning on or after 1/1/2007 Enacted by 6/1/2006 $ Millions			
	2006-07	2007-08	2008-09
Higher R&D credit rate	a/	a/	a/

a/ Loss of less than $250,000

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

<u>Revenue Discussion</u>

This bill is estimated to produce an insignificant revenue loss of less than $150,000 annually. The revenue impact is estimated as follows. The amount of research credit claimed by corporations with California annual total income of $1 million or less is estimated to be $172,000. This estimate is based on the data from the 2003 FTB corporate credit sample. Raising the regular research credit rate from 15% to 20% is expected to increase the amount of research credit claimed to $230,000, a revenue loss of $58,000. It is assumed that qualified technologies account for 20% of this loss, and that the higher research credit rate would induce small corporations to increase research five fold. Furthermore, the revenue impact for businesses under the PITL is assumed to be equal to 6 percent of the corporate impact. This 6 percent is the ratio of research credits claimed under the PITL relative to the CTL for the 2003 tax year. The estimated net revenue loss for 2003 is -$61,500 ($58,000 X 0.20 X 5 X 1.06).

ARGUMENTS/POLICY CONCERNS

This bill would allow a credit for an item that is already deductible as a business expense. By allowing both a credit and a deduction, a double benefit is provided for the same expenditure. Attached are amendments that would resolve this issue.

This bill does not contain a sunset date. Sunset dates generally are provided to allow periodic review by the Legislature.

This bill does not limit the number of years for the carryover period. Without a limit the department would be required to retain the carryover on the tax forms indefinitely because presently the bill would allow an unlimited credit carryover period. Recent credits have been enacted with a carryover limitation since experience shows credits are typically used within eight years of being earned.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2567
As Introduced February 23, 2006

AMENDMENT 1

On page 3, after line 6, insert:

(g) Any deduction otherwise allowed under this part for any amount paid or incurred by the taxpayer upon which the credit is based shall be reduced by the amount of the credit allowed under this section.

AMENDMENT 2

On page 4, after line 15, insert:

(g) Any deduction otherwise allowed under this part for any amount paid or incurred by the taxpayer upon which the credit is based shall be reduced by the amount of the credit allowed under this section.